RISING RATES AND IMPLICATIONS FOR CREDIT INVESTORS

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Introduction

As summer approaches, investors are going to feel the heat from an unlikely source: the Federal Reserve. As the Fed gears up to raise interest rates, investors are evaluating how the potential move may impact portfolios and markets. A rise in rates will have material implications on the future pricing of risk across asset classes, particularly credit.

The looming shift in monetary policy comes amid a multi-year rally in risk assets with credit spreads near historically low levels. The Fed, expressing cautious optimism about the strength of the US economy, appears to be on track to raise short-term interest rates by the end of the year, despite deflationary pressures at home and abroad. A departure from the Fed's zero interest rate policy will conclude an unprecedented accommodative monetary policy, almost twice the length of any period prior. The timing, pace and magnitude of the Fed's rate hike are important factors while assessing the impact of higher rates on markets and investment portfolios. While it is impossible to predict future Fed action, reviewing historical periods of tightening provides context for anticipating the potential impact on fixed income assets.

NEPC's findings show that, despite the restrictive nature of a Fed Funds rate increase on the domestic economy, credit spreads have historically remained stable for a considerable time following such an action. In other words, investors have been compensated for maintaining credit spread in their portfolios for a period of time following an interest rate hike.

In this paper we discuss the implications of a changing monetary policy for the US economy and credit assets, and appropriate fixed income strategies through which investors may benefit or protect their portfolio during this transition.

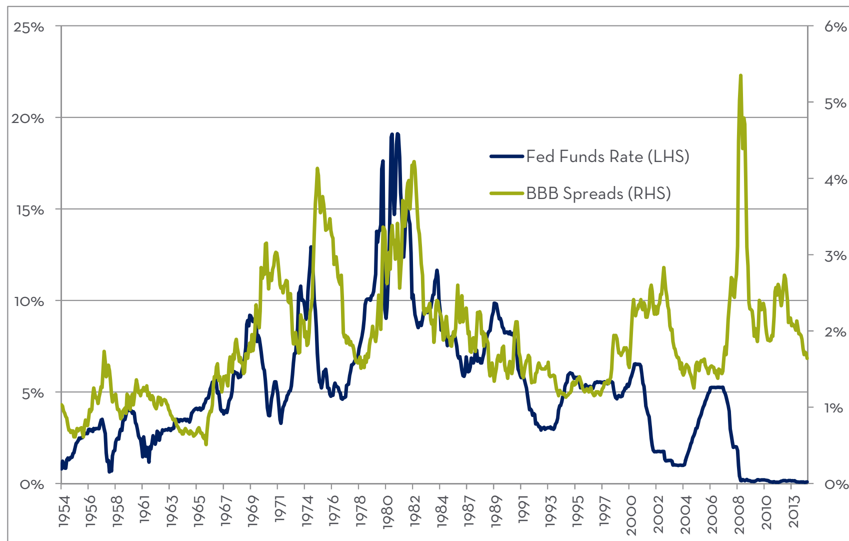
Historical Analysis of Tightening Cycles

Since 1954,[i] there are several instances of the Fed transitioning to a more restrictive monetary policy from an accommodative one. An examination of BBB corporate spreads[ii, iii] during this time shows extended periods when spreads remain flat and/or stable, interrupted only by relatively short-term spikes in spread volatility (Exhibit 1). Not surprisingly, these spikes coincide with highly-stressed economic scenarios such as hyper-inflation of the 1970s-1980s and, most recently, the Global Financial Crisis.

In addition to these events, there are periods of spread widening around when the Fed embarks on a contractionary monetary policy. While these moves occurred during various economic regimes—high and low growth—a common trend is rising inflation, with the economy at least on the verge of what economists and Fed officials perceive as "healthy."[iv] Historically, spreads on BBB credit have generally remained stable (Exhibit 2)

[i] *Federal Funds rate data are available going back to 1954.*
[ii] *BBB-rated corporations were selected for two reasons: (a) BBB-rated debt is empirically less sensitive to changes in interest rates, reflecting a higher embedded credit risk premium; and (b) the constituency of higher-rated indices, for instance AAA, has changed drastically over the years. Three decades ago there were approximately 60 AAA-rated corporations. Today, there are just three.*
[iii] *Spreads are calculated by taking the yield on Moody's BBB-rated corporate debt and subtracting from it the yield on the 10-year constant maturity US Treasury.*
[iv] *"Healthy" is defined as real GDP growth in the 2%-3% range and unemployment rates below 6%.*

Exhibit 1: Fed Funds Rate vs. BBB Corporate Spread



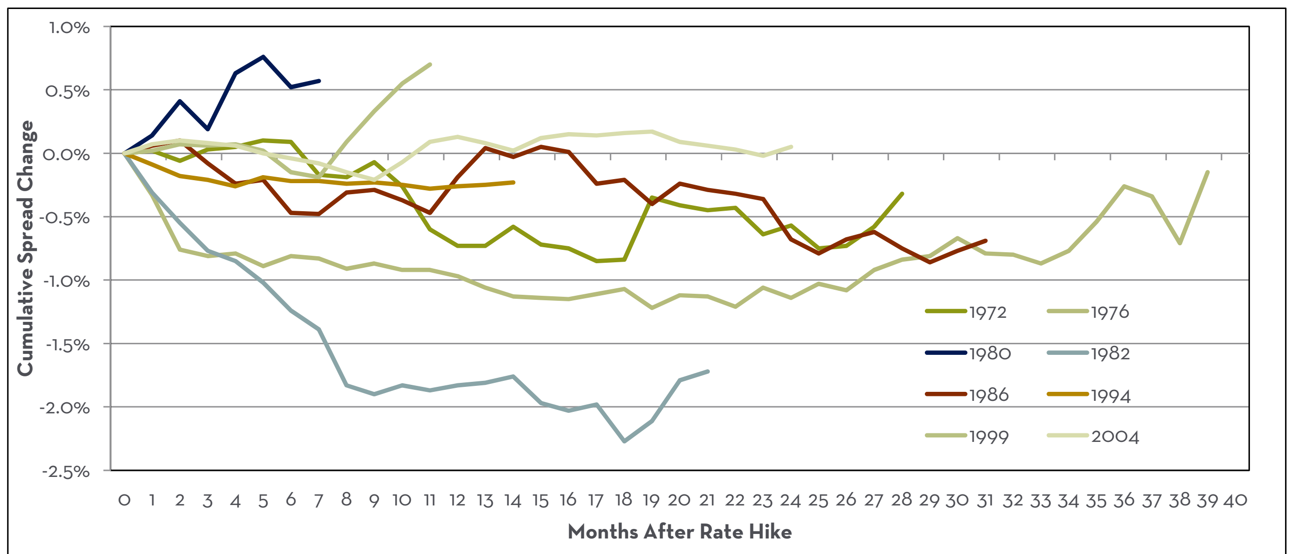
Source: Federal Reserve Economic Data (FRED), Moody's Investors Service

following a Fed rate hike through the tightening cycle.[v] In fact, in several cases, despite the damping economic effects of a rate increase, spreads contracted over the tightening period due to the perceived or actual strengthening of labor markets and the domestic economy. Furthermore, a clear relationship between Fed action and credit risk premiums indicates that historically, credit spreads widened approximately two years *after* the Fed began to increase short-term interest rates (Exhibit 3). This phenomenon is intuitive: increasing short-term rates has the intended effect of slowing credit growth, reducing money supply and increasing cost of capital. This eventually softens top- and bottom-line growth for corporations, making these entities presumably less creditworthy or riskier investments in the eyes of credit ratings agencies and investors. Investors, in turn, demand greater compensation to lend to these borrowers, resulting in wider credit spreads.

The data reveal another observation: the tightening typically takes longer to implement than the easing cycle that preceded it. This is no coincidence: The Fed implicitly targets an inflation rate of approximately 2%, meaning it prefers a little inflation over zero inflation or deflation. To curb the potential damaging effects of deflation, such as falling prices and anemic credit growth, the Fed is able to quickly implement accommodative policies (decrease rates). In contrast, when markets are recovering from a period of low growth and deleveraging, the Fed is more likely to raise rates in a measured and methodical way so as to not disrupt economic progress.

To be sure, though the above analyses are compelling, the fact is that each tightening cycle occurred during different periods of growth and inflation. To this end, being cognizant of the current economic backdrop is essential. Each time the Fed began raising interest rates (Exhibit 4), the economy has been in varying states, for instance, stagflation in the early 1980s and the Great Mod-

Exhibit 2: Historical Spread Movements Post-Rate Hike

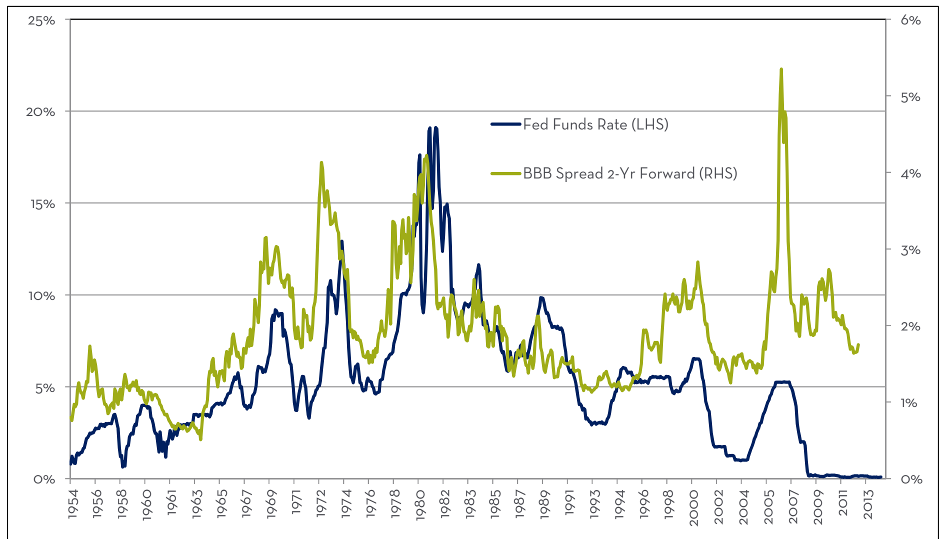


Source: FRED, Moody's

[v] *Tightening cycle is defined as the period of time in which the Federal Reserve is raising the Federal Funds target rate.*

eration of inflation and interest rates in the 1980s-90s. However, aside from the hyper-inflationary and low-growth environment experienced in the early 1980s, most periods of rising interest rates occurred when trailing 12-month inflation was near or exceeded the 2% Fed target, and when growth was around 3%.

Exhibit 3: Fed Funds Rate vs. BBB Spread Advanced Two Years



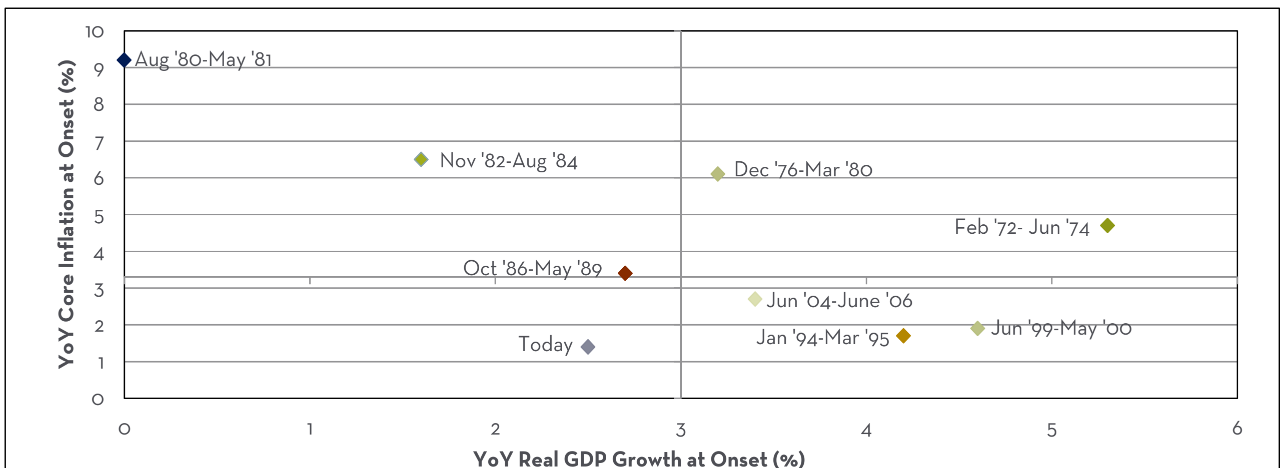
Source: FRED, Moody's

Where Do We Stand Today?

We remain in a low-rate environment with the 10-year Treasury yield settling below 2% as of April 20, 2015. The Fed has indicated its intention to raise interest rates this year, an action contingent upon continued improvement in the US economy and labor market.

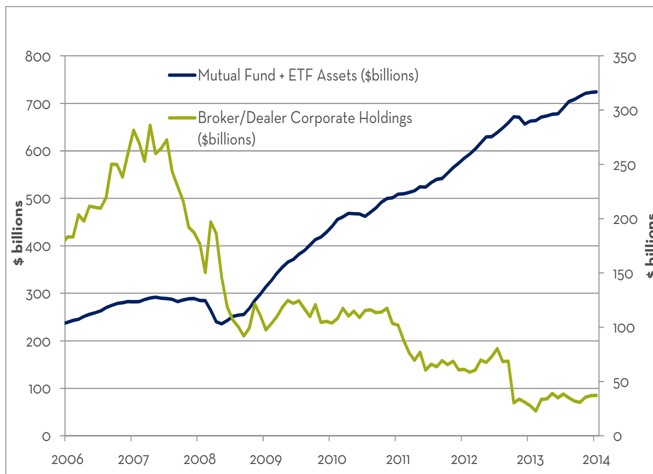
Prices, as measured by the Personal Consumption Expenditures Index (PCE), the Fed's preferred measure of inflation, increased 1.4% in 2014 and GDP grew at a rate of 2.5%. These statistics underscore the slowly improving economic growth in the US since the financial crisis, and the lack of inflationary pressures in the market. Potentially making the Fed's decision more difficult is the quantitative easing program recently kicked off in the Eurozone and declining oil prices, which may impact domestic growth and inflation. This suggests that Fed officials may hesitate to embark on a hawkish policy and, even when they do, it is likely to be cautiously and gradually implemented. This would ensure inflation and growth and their underlying drivers have sufficient traction to support a sustainable economic recovery at home. A potential scenario is the Fed increases short-term rates too quickly or raises rates so high that domestic growth stalls. In this instance, spread volatility will likely increase and credit assets would perform relatively poorly. In response, the Fed may revert to lower rates and an accommodative policy to avoid falling prices and a sputtering economy. Still, history suggests that the coming tightening cycle will be prolonged and carefully executed. If this is the case, credit spreads will likely remain low and stable for an extended period.

Exhibit 4: Prevailing Economic Conditions at Time of Rate Hikes



Source: FRED, Bureau of Economic Analysis

Exhibit 5: Broker-Dealer Balance Sheets and Retail Vehicle Assets



Source: Securities Industry and Financial Markets Association (SIFMA), Federal Reserve, Investment Company Institute (ICI)

The Current Credit Market

In order to understand the potential reaction of credit markets to the Fed raising rates, we must revisit the past. It is not only imperative to understand the elements still relevant relative to history, but also what may be different. To this end, we include in our comprehensive analysis four critical factors: liquidity, valuations, fundamentals, and macroeconomic factors/ Fed policy.

Liquidity: New financial regulation stemming from the Financial Crisis has eroded trading in fixed income markets. Banks are constrained in the amount of capital they can commit to their trading functions, limiting their ability to warehouse securities and provide liquidity. In addition, since 2008, fixed income assets in retail-oriented vehicles, such as exchange-traded funds and mutual funds, have skyrocketed at the same time broker-dealer inventories have plunged (Exhibit 5). This not only affects trading costs in the form of wider bid-offer spreads, but also poses potential risks in the event of a market selloff.

Valuations: Relatively riskier assets remain richly valued despite the selloff in high yield bonds in December. These valuations, fueled by the easy money policy in the US, low interest rates in developed markets and the relative strength of the domestic economy, have resulted in spread levels well below their long-term average (Exhibit 6).

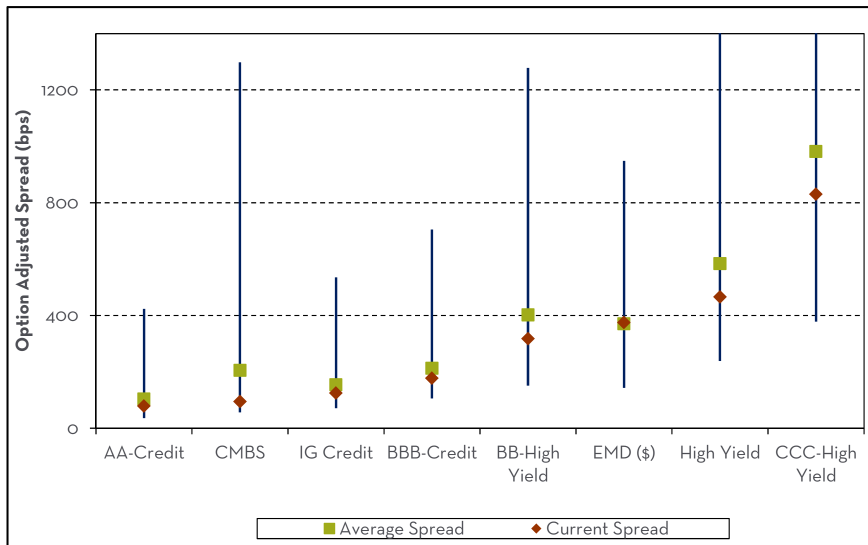
Fundamentals: US corporate balance sheets remain robust with healthy cash levels and profit margins near record highs. Leverage has increased slightly, but not to alarming levels; also, interest coverage ratios have improved substantially. Corporations, taking advantage of investor demand and cheap financing, have pushed debt maturities out, reducing the risk of a significant default cycle in the near term. On the flip side, there is an uptick in shareholder friendly activities, for instance, leveraged buyouts, mergers and acquisitions and share buy-backs, which often arise towards the latter stages of a credit cycle. Although currently manageable, these aggressive practices are likely to grow.

Macro: Fed policy, a primary macro risk in the near term, may have a material impact on credit pricing. Economic data indicate a gradually improving US economy and a strengthening labor market. While our analyses show that holding spread assets can offer gains for a considerable amount of time—even after a contractionary monetary response—it is still vital to monitor the Fed's communication and reaction to economic indicators. The Fed will consider many of the factors we mention, including lower oil prices and quantitative easing in Europe, while contemplating policy.

At NEPC, we believe credit remains a valuable asset in the current market, though valuations and liquidity pose potential concerns in the near term. The choice of vehicle through which credit exposure is obtained has been paramount in navigating the investment landscape. For instance, a single-sector exposure to spread assets—be it high yield bonds, bank loans or investment grade credit—has been an excellent trade since the Financial Crisis.

That said, the market today is different; long-only single-sector exposure to liquid credit is not as attractive a forward-looking investment. There are two potential options that may be suitable for portfolios seeking or requiring credit exposure. One, maintain exposure to traditional fixed income but with greater flexibility. For instance, multi-sector fixed income strategies invest across spread asset classes, benefiting from security selection and sector rotation. Given the multitude of macro and idiosyncratic factors driving debt performance, managers with broad credit capabilities and flexibility may be able to add value in different markets. Straying from a benchmark-aware approach allows managers to seek value outside of traditional indexes; in doing so, they can potentially avoid liquidity-driven selloffs in credits that are heavily owned by retail vehicles. Additionally, many of these strategies contain guidelines to utilize interest rate and credit deriv-

Exhibit 6: Credit Sector Spreads– 15 Years



Source: Barclays Live, as of 3/31/2015

atives in order to manage duration and credit beta exposure.

Another option is for investors to explore alternative investment structures such as credit hedge funds and direct lending strategies. For instance, direct lending funds lend to small- and medium-sized companies at attractive yields, seeking to fill the void left by banks constrained by post-Crisis regulation. These investment options have the potential for greater returns and/ or increased diversification benefits.

Conclusion

Investors, advisors and economists are keeping a watchful eye on the Fed to gauge its mood and intention as it sets forth to tighten monetary policy. While a shift in policy has direct implications for the domestic economy and pricing of risk premiums, NEPC analyses demonstrate the impact is not immediate, especially for default rates. Rather, spreads have historically remained stable for an extended period following rate increases. This means that investors can feel comfortable maintaining spread exposure, particularly given the economic state at home and the potential for delayed Fed action. Absent a policy error by the Central Bank, spreads can remain at their current levels for a considerable time. With a rate hike on the horizon, investors should examine their portfolio's credit exposures, assessing the merits of the investment and exploring whether the mandate can be optimized. Selecting an appropriate investment vehicle is paramount given valuations and liquidity in traditional credit sectors. Investors should consider more flexible or opportunistic options in alternative and conventional structures, such as multi-sector credit, credit hedge funds, or direct lending opportunities. So, the question really is *how* and not *when* while evaluating your credit exposure in today's market.

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